recognized that the SLC was the most cost causative approach to recovering that investment,[30] the Commission set the SLC rate to recover only 50% of the actual cost of the loop.[31] The remainder of the cost was, and still is, recovered through the Carrier Common Line ("CCL") charge and the Residual Interconnection Charge ("RIC").

The Joint Board recommended that the CCL be moved to a flat-rated charge.[32] Clearly, moving the CCL to a flat-rated charge by reducing the SLC (which is already flat-rated) is totally at odds with the notion of total recovery of the loop investment.

Furthermore, reducing the SLC will not eliminate the need to assure carriers the recovery of their investment. The recovery will need to come from somewhere. It must be recovered from an explicit charge, such as the SLC, rather than from a non-causative entity or conduct or other implicit subsidy. As Commissioner Chong observes,

> Any policy that, in essence, shifts or perpetuates the recovery of these costs from interstate providers can, at best, be described as an inefficient "shell game" on consumers. It is a shell game because in the competitive interstate telecommunications market, service providers will have to pass these costs along to consumers in the form of either flat rated charges or higher rates on long distance bills. Any potential savings that consumers would receive from a SLC reduction on their local phone bills may well be offset by an increase to their long distance bills.[33]

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[30] See CC Docket No. 78-72, Phase I, Third Report and Order, 93 FCC 2d 241, 243 ¶ 3 (1983).

[31] See id. at 243-44 ¶¶ 4-5, 279 ¶ 124, 284-85 ¶¶ 146-47, 291-94 ¶¶ 176-85.

[32] Decision ¶ 776.

[33] Separate Statement of Chong at 11-12.

Second, from a procedural perspective, the final decision on the level of the SLC is best resolved in the Commission's upcoming access reform proceeding. Given the correlation between the CCL and the SLC with respect to loop investment, even addressing a reduction of the SLC in a universal service proceeding makes little sense.

Additionally, failure to increase the SLC would only require additional funds and funding mechanisms for the USF or other explicit-subsidy mechanisms, in light of the fact that implicit subsidies are now prohibited under the 1996 Act, in urban as well as rural areas. Should the Commission choose to require continuation of below-cost SLCs, it must explicitly recognize this subsidy and deal with it appropriately under the 1996 Act.

An SLC reduction in the context of universal service implementation simply makes no sense and, if adopted along the lines suggested by the Joint Board, would be contrary to the public interest.

IV. THE JOINT BOARD'S RECOMMENDATIONS ON THE SCOPE OF UNIVERSAL SERVICE SUPPORT SHOULD NOT BE ADOPTED ACROSS THE BOARD. ITS "SERVICE AREA/SUB-UNIT" RECOMMENDATIONS SHOULD BE ADOPTED; BUT ITS FUNDED SERVICES RECOMMENDATIONS SHOULD NOT.

A. The Joint Board Correctly Determined That A "Service Area" For Carrier Service Obligations Need Not And Probably Should Not Be The Same As The Targeted High-Cost Support Area

The Joint Board notes that Section 214 grants to state commissions the authority and responsibility to designate the area throughout which a carrier must provide the defined core services in order to be eligible for universal service

support.[34] U S WEST supports the Joint Board's recommendation that "the Commission urge the states to designate service areas for non-rural telephone companies' areas that are of sufficiently small geographic scope to permit efficient targeting of high-cost support"[35] and which are not "unreasonably large."[36]

Not surprisingly, based on U S WEST's past advocacy, we support the use of CBGs for targeting universal service support for high-cost and insular areas.[37] U S WEST endorses the suggestion of the Joint Board that the concept of "service area" (if it is larger than a CBG) not preclude the further subdivision of the service area into CBGs as the "sub-unit" for targeting high-cost support.[38] The total support for a service area would be determined by identifying the high-cost areas included in the overall service area and determining "the level of support payments that a carrier would receive for the overall service area based on the sum of the support levels as determined by the costs of serving each of the disaggregated areas."[39] This approach is the most consistent with targeted support, incorporating the most equitable disbursement methodology available.

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[34] Decision ¶ 175.

[35] Id.

[36] Id. ¶ 176.

[37] Id. ¶ 170 and n.561.

[38] Compare id. ¶ 178 ("We recommend that the Commission, where necessary to permit efficient targeting of universal support, establish the level of universal service support based on areas that may be smaller than the service area designated by the state.").

[39] Id.

B. The Joint Board's Recommendations With Respect To USF High-Cost Support Only For Primary Residences And Primary Lines Is Inconsistent With Current Carrier Obligations To Serve. Also, While The Proposal Might Be "Ideal" In Some Kind Of Abstract Sense, It Appears Quite Problematic To Implement.

The Joint Board determined that universal service high-cost support should be provided, in part, "to residential customers . . . carried on a single connection to a subscriber's principal residence."[40] The Joint Board's recommendation with respect to second and multiple lines is inconsistent with existing carrier obligations to serve -- including an obligation to serve a customer-served residence. Either the obligation or the recommendation should be changed.

Furthermore, while it might be "ideal" policy to suggest that only primary lines be supported, we believe that such will be difficult to administer, given LEC current systems and account tracking (which is generally done by telephone number, not by address). The Commission should avoid converting LECs into the Telephone Police with respect to universal service support implementation.

While U S WEST appreciates the idealism associated with the Joint Board's proposal, i.e., that there should be some "need" component associated with universal service support and that -- if an individual can afford a second line -- the need seems nonexistent,[41] universal service support is not just to address the need of the end-user recipient but the costs of the "obligated" carriers to provide service. To the

[40] Id. ¶ 89.

[41] Compare Separate Statement of Ness at 2 ("Prudence . . . requires that . . . we limit universal service support to single-line residences . . . There is no reason why ratepayers as a whole should bear the burden of supporting multiple lines to a single residence [or] single lines to second homes[.]").

extent that carriers are obligated to install second and multiple lines on a subsidized basis (i.e., below-cost recovery for the line itself, with costs that far exceed the average), carriers should be able to have those costs "supported."

Alternatively, carriers should have no obligation to provide more than a single connection to a residence. Second and multiple connections should be deregulated in high-cost areas if they are not going to be supported.

To the extent there is a common carriage obligation to provide second (or multiple) lines to subscribers in high-cost areas, and to the extent that those lines are to be made available at less than the carrier's full cost plus profit, the provision of these lines is being subsidized by something -- just as the first line is being subsidized. To the extent that the subsidy is "implicit," it is contrary to the Congressional goals associated with universal service, whether it is the first or third line that is being subsidized.

As a matter of regulatory and social policy, the implicit subsidy to any of the residence lines in a high-cost area should be eliminated. The elimination of support can occur either from removing the lines from regulation or by making explicit support received as "high-cost" lines provided by carriers with legal obligations to provide them. The former approach would reduce the size of the USF, while the latter would increase it somewhat.

Furthermore, there is no doubt that the Joint Board's recommendation will be impossible to administer to the extent that different carriers are serving different residences. It may even be problematic with respect to multiple lines, to

the extent that not all the lines are billed to the same entity at the same address. The proposal does not appear supported by either specifics or predictability.[42] Indeed, perhaps the only way that such a restriction could be implemented is through some sort of customer "certification," i.e., that the customer is receiving support only for its primary residence and its primary line. Whether such a certification program can be proven under a sound cost/benefit analysis is unknown, at this time.

V. U S WEST SUPPORTS AN FFB OVER AN "AVERAGE REVENUE PER LINE" AS THE APPROPRIATE "BENCHMARK" FOR DETERMINING THE DISTRIBUTION OF HIGH-COST SUPPORT.

U S WEST supports the finding of the Joint Board that "a national benchmark would enable the Commission to assure a reasonable support level to all carriers, and would be easier to administer than state or local benchmarks."[43] However, we disagree with the Joint Board that its proposed benchmark is the appropriate one.

The Joint Board proposes a funding benchmark (a figure representing a maximum amount a subscriber would have to pay in furtherance of a carrier's cost

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[42] The Joint Board acknowledged that it supported "the concept of administrative simplicity," yet declined to specifically endorse the notion as an additional "guiding principle" with respect to universal service funding and distribution mechanisms (Decision ¶ 27), believing, as it did, that Section 254(b)(5)'s requirement that support mechanisms be "[s]pecific and *predictable*," (id., emphasis added) already encompassed "administrative simplicity."

The Joint Board clearly acknowledged that predictability in the area of universal service funding and distribution mechanisms was an integral part of the statutory fabric. Yet, the Joint Board's recommendation that only services to primary residences be supported flies in the face of such predictability.

[43] Id. ¶ 314.

recovery and above which a carrier could seek universal service support)[44] for USF distributions in high-cost and insular areas based on the nationwide average revenue-per-line,[45] including what the Joint Board calls "discretionary services."[46] While the Joint Board believes that the use of its recommended methodology for deriving a federal benchmark would "be easy to administer and . . . set to minimize the probability that residential rates would increase while the new support mechanisms are being implemented,"[47] the Joint Board is in error. Its proposal would not achieve its professed goals and would inappropriately continue the insinuation of implicit subsidies into the universal service environment.

In light of these flaws, U S WEST continues to support our FFB of $30. Our proposal results in the establishment of a reasonably sized high-cost fund,[48] while not suffering from the infirmities associated with the Joint Board's proposal outlined below. Furthermore, the $30 figure finds support for its reasonableness from other sources. It is a small amount less than the highest statewide average residential rate[49] (thus, it is supported by the general "affordability" correlation the

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[44] Id. ¶ 312.

[45] Id. ¶ 311. There would actually be two benchmark figures: one for residential services and one for business services. Id. ¶ 312.

[46] Id. ¶ 310 and n.1002 ("Discretionary services include services that are added on to basic local service, e.g., call waiting, call forwarding or Caller ID.").

[47] Id. ¶ 309.

[48] See discussion herein, with regard to how this $30 would be divided between investment and expense and recovered from the USF.

[49] Based on a U S WEST price comparison analysis of RBOC basic residential service, $30.11 is the highest state average residential service price in the nation. This analysis attempts to compare prices for equivalent flat-rated residential

Joint Board found to exist between rates and subscribership levels),[50] and it corresponds generally to the measure of affordability found in the "1% of the national median household income" model proposed by certain commentors.[51]

In no event should the Joint Board's recommendation be adopted. It is contrary to the statutory requirement that universal service support be explicit, rather than implicit, and that the support be specific and predictable. While the Joint Board claims that its chosen benchmark is an advantageous choice of benchmark because it "will provide carriers the incentive to upgrade their service offerings in high-cost areas, and therefore, maintain high quality service in rural areas that is comparable to the service offered in urban areas,"[52] it nowhere demonstrates how its proposal would accomplish such a result, or how it would accomplish it better (or differently) than any other benchmark.

On the other hand, the infirmities of the Joint Board's proposal are evident. First, inclusion of vertical services revenues continues to incorporate an implicit subsidy flow into local loop investment. Such subsidy flows should be eliminated, to the greatest extent possible, from universal service considerations. Universal

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service across the nation by taking into account call patterns, local calling areas, tariffed prices, suppression/repression adjustments, and call distribution assumptions.

[50] Decision ¶ 127.

[51] See Decision at ¶ 121 and n.378 referencing Southwestern Bell Telephone Company ("SWBT") and the United States Telephone Association ("USTA").

[52] Id. ¶ 313.

service support mechanisms should not affirmatively count on or incorporate such revenues into benchmark funding figures.

Second, subsidy revenues associated with the current average revenue per line are certain to be reduced as the result of competition,[53] a phenomenon the Joint Board itself acknowledges.[54] The inclusion of such revenues into any benchmark funding figure would require more regulatory oversight and review to ensure an appropriately sized fund than would the adoption of a different methodology and figure.

For all of the above reasons, U S WEST believes that our proposed $30 FFB is the most appropriate benchmark.

VI. THE PURPOSE FOR USING A COST PROXY MODEL IN THIS DOCKET IS TO IDENTIFY HIGH-COST AREAS WHICH ARE ELIGIBLE FOR USF SUPPORT, NOT TO ESTABLISH RATES FOR COMPETITIVE PROVIDERS. U S WEST CONTINUES TO SUPPORT THE BCM2, BELIEVING IT IS THE BEST PROXY MODEL AVAILABLE TO PROPERLY TARGET HIGH-COST SUPPORT TO APPROPRIATE GEOGRAPHIC AREAS.

A. U S WEST Supports The Joint Board's Recommendation To Use A Cost Proxy Model.

The purpose of a cost proxy model in this docket is to estimate the cost of providing basic local telephone service in small geographic areas within the U.S.

[53] The Commission's First Report and Order, also, to the extent it survives appeal, will have the patent effect of reducing these revenues, since the Commission deemed vertical services as unbundled network elements. First Report and Order ¶ 419.

[54] Decision ¶¶ 310-11.

The use of small geographic areas allows the model to identify specific areas which are high-cost to serve because of the physical characteristics of the area.

The Joint Board recommended that the Commission use a proxy model, based upon forward-looking economic costs for the provision of basic telephone service, to determine support levels for universal service.[55] U S WEST agrees with the Joint Board's conclusion that "using cost estimates generated by proxy models is a reasonable technique for determining forward-looking costs"[56] for purposes of helping to identify high-cost areas and to devise appropriate support mechanisms. If cost proxy models are properly designed and if the assumptions and inputs are not selected to achieve a pre-conceived result, the models can be competitively neutral, because they are not based upon an individual company's costs.

B. U S WEST Supports, In Part, The Joint Board's Cost Proxy Model Recommendation.

The Joint Board considered four proxy models -- the BCM,[57] the BCM2, the CPM,[58] and the Hatfield model. However, it did not recommend any one of these models, because it believed that none of them was developed sufficiently.[59] It said

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[55] Decision ¶ 275.

[56] Id. ¶ 276.

[57] The BCM was developed by U S WEST, Sprint, NYNEX, and MCI, joint sponsors. It was designed as a high-level, theoretical local loop provisioning model designed to reflect relative differences in costs related to geography, terrain, and household density. It was designed to produce only enough cost provisioning information to identify these relative cost differences.

[58] The CPM was developed jointly by Pacific Bell and INDETEC, International. It uses grid cells, rather than CBGs, to calculate the cost of providing service. It is based on Pacific Bell's California network.

[59] Id. ¶ 268.

that a "properly crafted proxy model" could be developed to calculate forward-looking economic costs for specific geographic areas and could be used as a reasonable input to determine the level of support carriers may require to serve a high-cost area.[60]

The Joint Board concluded that the BCM2 and the Hatfield Model (Version 2.2, Release 2) appear to offer the best available basis for development of an acceptable proxy model.[61] U S WEST agrees with the conclusion that the BCM2 model provides a well-reasoned and sound basis for development of a proxy model to achieve the Joint Board's and the Commission's objectives in this docket. U S WEST disagrees with the recommendation that the Hatfield Model offers the same promise.

The BCM2 model was developed by U S WEST and Sprint. It is a high-level model using census block data to identify the location and density of households in a state. It responds to the comments on the BCM and a series of workshops. It enhances the engineering and costing assumptions in the original version and allows users to input their own underlying cost factors and user prices.[62] The model uses this data together with engineering information to formulate the average cost to provide voice grade telephone service to those households. The model is a forward-looking engineering model that estimates the investment and cost that

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[60] Id.

[61] Id. ¶ 279.

[62] Id. ¶ 249.

would be required to replicate the network in place today. The BCM2 model best accommodates the criteria outlined by the Joint Board as being essential to a quality proxy model.[63]

The Hatfield Model was originally commissioned by MCI, and later adopted by AT&T and other interexchange carriers, as a cost study which purports to show that the cost of local loops is very low relative to other industry cost studies. It has evolved over time. Much of it has been closely guarded from scrutiny by its developer and sponsors.

The Hatfield Model does not offer the same promise as the BCM2, because the model was designed for a purpose other than to identify high-cost areas which would be eligible for USF support. It is U S WEST's position that the Hatfield Model does not merit further consideration by the Commission.

C. The Hatfield Model Does Not Offer A Reasonable Basis For Development Of An Acceptable Proxy Model Because It Artificially Depresses Costs.

The Hatfield Model fails to meet the requisite objectives of a cost proxy model articulated by the Joint Board. A proper proxy model (1) must not be susceptible to manipulation; and (2) must be competitively neutral. The Hatfield Model is neither.

The Hatfield Model is a results-driven model which can be manipulated to produce whatever cost answer its sponsors desire. This defect in the design is fatal, particularly in view of the articulated purpose for a cost proxy model in this docket.

[63] Id. ¶ 277.

The developer and the sponsors of the Hatfield Model proffer it as an all-purpose tool which can be used not only to develop costs for USF high-cost support but also as a Total Service Long Run Incremental Cost ("TSLRIC") model which can be used to develop broad-based costs of unbundled network elements in state arbitration proceedings.

These objectives cannot be achieved by a single, all-purpose model. AT&T attempts to use the Hatfield Model as a basis for pricing unbundled network elements provided by incumbent LECs.[64] However, unlike the purpose and targeted view of a cost proxy model in this docket, TSLRIC is designed to give the forward-looking cost of providing service to all of a company's customers.[65] The Hatfield Model is not a TSLRIC model for that purpose and is not a properly designed cost proxy model to target the high-cost segment of a company's customers in this docket.[66] The Hatfield Model does not, and will not, lead to the development of support mechanisms sufficient to preserve and advance universal service.

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[64] U S WEST provided the following example where the dual objectives of the Hatfield Model are at cross-purposes: "U S WEST believes that the Hatfield Model seriously underestimates the cost of constructing a network to provide basic telephone service. When AT&T was attempting to convince the Commission that the provision of unbundled network elements by incumbent local exchange carriers ("LEC") was necessary, they estimated the cost of constructing a loop at approximately $1,250. Now, when it comes to the pricing of those unbundled elements, AT&T and Hatfield say that the cost for U S WEST's territory (which is among the least populated in the nation) is more like $400 per loop." U S WEST's Comments on Cost Proxy Models at 7.

[65] U S WEST's Reply Comments, at Appendix E at 4.

[66] 47 USC § 254(b)(5) (1996).

How does the Hatfield Model artificially depress costs? In attempting to achieve its sponsors' dual, but conflicting, objectives, critical assumptions and inputs have been manipulated.

1. Hatfield Understates Drop Costs.

The Hatfield Model does not model drop costs, but uses a single value from a New Hampshire study which estimated the cost of adding a customer to the existing network. As a result of this, the Hatfield Model drop cost is grossly understated. The cost included in the Hatfield Model for the network interface device ("NID") is $30 and the installed drop wire is $40 for a total of $70.

U S WEST has just completed a recent comparison of these Hatfield cost assumptions with U S WEST's actual costs.[67] While Hatfield uses a constant $70 drop and NID cost factor, the comparison reveals that U S WEST's actual forward looking costs are $135.75 for aerial drops and $157.20 for buried drops:[68]

Drop

	U S WEST Value	Hatfield Value	
Investment per line		$40.00	$10 material $30 labor for 2-pair drop
	$112.64		Aerial 2-pair drop
	$117.65		Buried 2-pair drop

NID

	U S WEST Value	Hatfield Value

[67] Direct Testimony of Garrett Y. Fleming, Colorado PUC Docket No. 96S-331T (filed December 13, 1996) ("Fleming Direct Testimony").

[68] Id. at Exhibit 4 at 13.

Investment per line		$30.00	$15 material $15 labor
	$23.11		Aerial 2-pair drop
	$39.63		Buried 2-pair drop

2. Hatfield Understates Distribution Facilities.

The Hatfield Model significantly understates the amount of distribution facilities which will be required to serve most census block groups. Hatfield assumes that each census block is square. The number of distribution cables utilized in each CBG ("Census Block Group") is then determined based on the density in lines per square mile. For example, the number of distribution legs assumed by Hatfield based on the CBG density is:

Number of Lines Per Square Mile	Number of Distribution Legs
0-5	2
6-200	4
201-650	4
651-850	4
851-2550	6
>2550	8

Hatfield assumes that each distribution cable will transverse 62.5% of the length of the census block group. In urban areas, this results in a gross understatement of the facilities needed to serve typical CBGs. For example, an average CBG has approximately 400 homes. In urban areas, these homes are located throughout the CBG. In a typical residential area, where household density is approximately 800 households per square mile, a CBG would consist of 20 rows of

homes 20 houses deep in approximately 1/2 square mile. Normal distribution designs would place one distribution line between every two rows of houses. If there are 400 homes in a CBG, ten distribution cables would be required to serve the 20 rows of houses. However, in this density group Hatfield assumes that only four distribution cables would be required. This understates the number of distribution cables by 60%. Therefore, Hatfield compounds the understatement of distribution cables by understating the number of cables necessary to serve the CBG in addition to underestimating the length of each distribution cable.

Conversely, in rural areas, the Hatfield Model overstates the need for distribution facilities. This is because large segments of the rural CBG's are uninhabited. Facilities would not be needed in those areas. However, the Hatfield Model does not take this into account.

Overall, U S WEST has found that the Hatfield Model underestimates the total miles of loop plant that actually exist in U S WEST states by up to 70%.

3. Hatfield Understates The Percentage Of Buried Placement.

The Hatfield Model assumes 50% aerial placement of all wire-line facilities.[69] This assumption is based upon the opinion of an ex-NYNEX engineer who provided input to the model. However, this assumption does not comport with U S WEST's actual experience. For example, in Colorado only 13% of U S WEST's wire-line facilities are placed using aerial facilities. And the comparison of the relative costs shown above illustrates that U S WEST's costs for buried placement are greater

[69] Id. at 46.

than for aerial placement. Again, Hatfield's assumption about the percent of aerial placement compared to buried placement is erroneous, but it furthers its sponsors' objective to depress costs.

4. Hatfield Understates The Cost Of Building And Installing Network Structures

The Hatfield Model assumes that a carrier building a new network would be able to share the costs of building and installing much of the network with other utilities. However, cost sharing among utilities typically occurs only when cable and other structures are being installed in new developments.

The Joint Board recognized this design defect: "The Hatfield model assumes that structures are shared equally by telephone, electric, and cable companies; this assumption reduces the assumed investment in structure to one third of their estimated cost. . . . We are unconvinced that sharing exists to the extent the Hatfield model presumes . . . ."[70]

The Joint Board's doubt is borne out by U S WEST's experience. For example, in Colorado, U S WEST estimates that some sharing occurs only 16% of the time for buried cable facilities and 50% of the time for aerial facilities.[71] Again, the Hatfield assumption regarding the likelihood of sharing the cost of facilities with other utilities clearly depresses the LECs' costs for such facilities. However, the hoped-for cost savings are not supported by the LECs' experience.

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[70] Decision at Appendix F ¶ 7.

[71] Fleming Direct Testimony at 44.

In addition, the Hatfield Model severely understates the total installation cost of buried plant in all but the highest and lowest density groups. In four suburban and urban density groups, the Hatfield Model default inputs are $2 and $3 per foot to install buried cable. It is impossible to install cable for these costs when obstacles such as existing streets, landscaping, and fences are regularly encountered.

5. Hatfield Understates Equipment Prices And Overstates Vendor Discounts.

The Hatfield Model reduces the material and installation prices for many basic network components utilized in both loop plant and interoffice plant. For example, the default installed prices of digital loop carrier equipment in the model is 44% lower than the prices U S WEST pays its vendors for similar equipment. The default installed price for equipment that Hatfield refers to as serving area interfaces is generally 50% less than the installed price U S WEST currently pays to utilize such equipment. Similarly, interoffice equipment, such as OC-12 regenerators, is also understated from the actual installed price U S WEST pays by a like amount.

6. Hatfield Uses Unrealistically Long Depreciation Lives To Depress Costs.

Depreciation lives in the Hatfield Model are historically derived rather than forward looking. It uses unrealistically long depreciation lives which have the effect of depressing costs. For example, it uses 18 years for switched facilities compared

to a typical life used by competitors (including AT&T) of fewer than 10 years. By using longer depreciation lives, Hatfield artificially depresses the LECs' costs.

7. Hatfield Understates Taxes.

The Hatfield Model has two inputs to compensate for taxes. First, Hatfield assumes a federal tax rate of 34%. Second, it uses a tax factor of 5% to cover all other taxes paid by an incumbent LEC.[72]

Presumably, the 5% tax factor used by Hatfield to cover all other taxes is intended to cover property taxes, franchise taxes, sales taxes, gross receipts taxes, customer sales taxes assumed, and state income taxes (where applicable). However, U S WEST's analysis of its own tax liabilities reveals that the 5% tax factor is not even sufficient to cover its property taxes, much less the remainder of the "other taxes."[73] This is yet another example of how the Hatfield Model artificially depressing costs.

8. Hatfield Understates The Cost Of Capital.

The Hatfield Model understates the cost of capital and, therefore, artificially depresses U S WEST's costs. For example, U S WEST compared the assumptions used by Hatfield with its actual capital costs. That comparison reveals a substantial understatement of the cost of capital by Hatfield:[74]

	U S WEST	Hatfield

[72] Id. at 46.

[73] Id.

[74] Id. at Exhibit 4 at 15.

Debt Percent	USWC market value debt ratio	28.00%	45.00%
Cost of Debt	Average of USWC's 10-year and 30-year maturity debt	7.50%	7.70%
Cost of Equity	Based on a series of discounted cash flow and CAPM studies of LECs and related industries	12.85%	11.37%
Equity Percent	Total capital less debt percent	72.00%	55.00%
Overall Cost of Capital	Weighted debt and equity	11.40%	9.72%

9. Hatfield Lacks Credibility Because It Manipulates And Understates Costs.

The conclusions which can be drawn from the comparisons and illustrations above are clear. The Hatfield Model dramatically, and artificially, depresses the costs of the LECs. This is the competitive objective of the model's sponsors in state arbitration proceedings. However, this is not the objective for a cost proxy model in this docket.

Section 254(b)(5) of the Act requires that the support mechanisms be sufficient to preserve and advance universal service. If the Commission adopts that portion of the Joint Board's recommendation which concluded that the Hatfield Model provides a reasonable basis for the development of an acceptable proxy model in this docket, the support mechanisms will not be sufficient to preserve, much less advance, universal service. The Hatfield Model should be rejected.

VII. U S WEST OPPOSES THE JOINT BOARD'S RECOMMENDED "GROSS REVENUES NET OF PAYMENTS TO OTHER CARRIERS" BASIS FOR USF ASSESSMENTS.

The Joint Board considered three different methods for assessing USF contributions: gross revenues, gross revenues net of payments to other carriers, and per-line or per-minute charges.[75] It recommended that the Commission adopt gross revenues net of payments to other carriers.[76] For the reasons discussed below, U S WEST opposes this recommendation.

A. Assessment of Gross Revenues Net Of Payments Made To Other Carriers Unnecessarily Burdens Wholesale Providers With Additional Costs.

The Joint Board said that it preferred the gross revenues net of payments made to other carriers method over the gross revenue net method because:

1. it avoids the double payment problem;

2. it would be administratively easy to implement;

3. it resembles a value-added contribution;

4. it requires wholesale carriers to directly contribute to support mechanisms; and

5. it would be difficult to track and verify retail revenues because no data is currently compiled.

U S WEST agrees with the Joint Board that the gross revenue net method is administratively simple and avoids double counting. However, the same can be said for the retail method. U S WEST sees no merit to the fact that the gross

[75] Decision ¶ 802.

[76] Id. ¶ 807.

revenue net method represents a value added approach. The following discussion will focus on points 4 and 5 above and will show that the Commission should adopt the retail method as the best approach to funding all Universal Support Funds.

Economically, the gross revenues net method and the retail method should result in the same charge to end users. Under the gross revenues net method, all carriers (wholesale and retail) incur equally support costs for the USF. In an economically rational environment, all users would pass these costs on to their customers (i.e., wholesalers to retailers and retailers to end users) (subject to supply and demand). No provider can gain an economic advantage over another because it has no control over the costs assessed to it. If this is the rational response, what is to be gained by assessing wholesalers who merely pass this cost on to retailers?

Consider a PC maker who relies on an Intel chip and only competes with other PC makers who rely on the same chip. If all makers must buy the Intel chip and purchase the same quantities, the base cost of their PC as represented by the Intel chip would be the same. No PC maker would have an economic advantage over other PC makers for this component. In reality, we know that the price of a PC has many more components and Intel does not control the chip market. Some PC makers buy in larger quantities to achieve a lower cost and a price advantage. Others buy chips from other chip manufacturers at a lower cost to achieve a price advantage. Plus there are other components of a PC which may give some PC makers a competitive advantage over other PC makers.

Under the Joint Board's proposal, telecommunications providers have no opportunity to achieve a cost advantage due to USF payments, because all providers must pay the same cost to the fund for each dollar of revenues earned.[77] Assuming all telecommunications providers are free to raise their prices for these costs, then the retail method and the gross revenues net of payments made method allow the same result. This can be shown with the following example:

Assumptions:

U S WEST retail revenue	$100
Wholesale cost of revenue	$ 90
Universal Service rate	10%

Support charge if U S WEST has retail customer:

Revenue	$100
Universal Service rate	10%
Payment	$ 10

Support charge for retailer who purchases wholesale service:

	Retail	Wholesale Pass through	Total
Revenue	$10	$90	$100
Universal Service rate	10%	10%	
Payment	$ 1	$ 9	$ 10

The pass through of these costs if what creates a competitively neutral outcome. If the wholesale were prevented from passing through its costs, clearly a

[77] A competitive advantage can be created by the Commission if it restricts an ILEC's ability to recover these costs. The best solution is an explicit surcharge.

competitively neutral result would not occur. The wholesaler would be forced to recover these costs from its retail customers, clearly putting it at a competitive disadvantage.

Based on the analysis above, it is difficult for U S WEST to understand why the Joint Board would recommend an approach that merely increases the costs of retailers which purchase from wholesalers. This is so, because all retailers will need to create administrative processes to determine what they owe to the fund, pay it, and then pass the costs on to their customers. A retailer who buys from a wholesaler pays this cost twice, first for their own costs and again in the cost paid to the wholesalers. Clearly, this additional cost outweighs any perceived benefit (and U S WEST doubts any benefit exists) of having wholesalers pay directly and puts the wholesaler at a competitive disadvantage.

U S WEST agrees that no formal nationwide tracking method exists today to identify retail revenues. This is a minor problem, however, because retail revenues are easily identifiable and trackable. All the Commission needs to do is provide a definition of retail revenues. U S WEST recommends the following straightforward definition: revenues received from customers who are not telecommunications providers. This definition would be easy to apply and administer.

B. The USF Assessment Should Be Identified As A Surcharge On The End User's Bill.

Unless the USF assessment is specifically identified on the end user's bill, it would not comply with the Act and would not be competitively neutral. The cost would be treated as the carrier's cost of doing business. However, the Act requires

that USF matters be treated explicitly.[78] If the USF assessment were specifically identified on the end user's bill, it would comply with this requirement in the Act. In addition, such an approach would be more appropriate from a public policy perspective.

If universal service funding costs are to be treated as a provider's cost of doing business, all providers should be on the same footing. Each provider should have the flexibility to increase any or all of its rates to cover these costs. However, incumbent LECs are constrained from raising rates for most services, i.e., local residential service. Incumbent LECs would, therefore, be required to attempt to recover these costs of doing business from more competitively vulnerable services. Thus, all USF providers would not be on the same footing.

Additionally, if the support cost becomes embedded in a provider's revenues, the providers would then be assessed a higher amount, because its revenues are higher due to the support costs. If some providers broke this cost out separately from their revenues and other did not, some providers would be unfairly penalized with a higher support payment.

Finally, it is important that all current implicit support be made explicit through the surcharge. Burying any portion of the support cost in a regulated provider's rates perpetuates implicit support and defeats the purpose of the fund.

U S WEST supports a method which bases the assessment on the retail revenues collected from the end-user customer by both facilities-based and non-

[78] 47 USC § 254(e).